

**NONCORPORATE BUSINESS TAXATION:
BEFORE AND AFTER
THE TAX REFORM ACT OF 1986**

by

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NONCORPORATE BUSINESS TAXATION: BEFORE AND AFTER THE TAX REFORM ACT OF 1986

I. INTRODUCTION

The Tax Reform Act of 1986 (TRA) marked a watershed in the history of taxation in this country. For the first time since the 16th Amendment permitted true income taxes, the top statutory tax rate on corporations will exceed the top rate on individuals. This fact, coupled with other changes in business taxation included in TRA, have prompted concerns that TRA's attempt to raise taxes on corporations relative to individuals may significantly increase the incentive for some business to shift into the noncorporate sector to avoid the corporation tax, resulting in an erosion of the corporate tax base.

Even before TRA, questions were frequently raised whether business had been "disincorporating," either shifting out of the corporate sector or starting in the noncorporate sector at a faster rate than in the corporate. The birth of master limited partnerships (MLP's) since the early 1980's was taken as one piece of evidence; the declining importance of the corporate income tax as another.

The question of why revenues from corporate income taxes have been falling was recently addressed by Auerbach and Poterba.¹ They demonstrate that corporate tax revenues have indeed fallen relative to GNP, corporate assets, and total Federal receipts since the early 1960's. They find that the explanation for this lies more in falling corporate profits than in legislative changes. They do not address the question of whether falling corporate profits have been accompanied by increasing profits or business income in the noncorporate sector. If that were true, then possibly, but not necessarily, the tax burden on all business and capital might not have fallen, even though less income was subject to the double tax on dividends.

This paper examines trends in the noncorporate sector before TRA and analyzes some of the factors that will influence the future after TRA.² Section II addresses the pre-TRA experience, and Section III turns to TRA and beyond.

Since taxes on income from noncorporate business are not separately reported on tax returns and therefore cannot be directly observed like corporate taxes, Section II focuses on measures of income used in the National Income and Product Accounts (NIPA) and income reported for tax purposes in the corporate and noncorporate sectors in order to draw inferences about trends in the two sectors. Section II also looks at the growth in MLP's and examines information from 1985 tax returns for the majority of MLP's in existence then. In Section III, the paper examines effects that the Tax Reform Act might have on noncorporate business in terms of revenue, relative incentives for corporate and noncorporate investment, and individual marginal tax rates on different types of income from noncorporate business. Section IV draws some tentative conclusions.

II. NONCORPORATE BUSINESS BEFORE THE TAX REFORM ACT OF 1986

A. Trends in NIPA Income

Throughout the postwar years until the early 1980's, income generated by business and capital in the private sector generally fell in relation to net national product (NNP). This was true of both the corporate and noncorporate sectors, although the decline was more erratic within the corporate sector. Table 1 and Graphs 1 and 2 show the percentages of NNP that came from various forms of business and capital income over the past four decades. From a high of 12.5 percent in 1950, the corporate share slipped to a low of 6.8 percent of NNP in 1982, with most of the drop occurring before 1970 (Graph 1). For the noncorporate sector as a whole and for the sector apart from "Other Private Business" (which is dominated by net rent and interest on owner-occupied housing), the decline was more persistent but not as severe. Again, most of the decline took place before 1970. The noncorporate share of NNP registered 18.8 percent of NNP in 1950, 13.8 percent in 1970, and dropped to a low in 1982 (and 1983) of 13.3 percent.

Underlying the trends for both sectors is a steady increase in the income paid out in interest, particularly since the mid-1960's, leaving corporate profits and proprietors' income falling more sharply and persistently as a share of NNP (Graph 2). In 1950, corporate profits (with capital consumption and inventory valuation adjustments) accounted for 12.7 percent of NNP, for 7.3 percent in 1970, but only 4.4 percent in 1982. In the noncorporate sector, proprietors' income (with IVA and CCA) for sole proprietorships and partnerships was more than twice as large, relative to NNP, in 1950 as it was in 1982: 14.6 and 6.3 percent, respectively. A partial explanation for the rise in income going to interest might be that it reflects a rational, profit-motivated response to inflation for both corporate and noncorporate

Table 1

INCOME FROM BUSINESS AND CAPITAL IN THE PRIVATE SECTOR, SELECTED YEARS, 1950-1986
PERCENTAGE OF NET NATIONAL PRODUCT

	1950	1955	1960	1965	1970	1975	1980	1981	1982	1983	1984	1985	1986
1. CORPORATE-TOTAL	0.125	0.119	0.099	0.120	0.085	0.086	0.080	0.082	0.068	0.083	0.091	0.088	0.086
2. Profits	0.127	0.121	0.099	0.118	0.073	0.072	0.059	0.059	0.044	0.061	0.070	0.069	0.067
3. Net Interest	-0.002	-0.001	-0.000	0.002	0.012	0.014	0.022	0.023	0.025	0.022	0.020	0.019	0.019
4. NONCORPORATE-TOTAL	0.188	0.171	0.167	0.157	0.138	0.139	0.133	0.134	0.133	0.133	0.138	0.141	0.148
5. SOLE PROP'S & PARTNERSHIPS-TOTAL	0.148	0.124	0.113	0.104	0.093	0.097	0.089	0.086	0.081	0.081	0.086	0.088	0.092
6. Proprietors' Inc	0.146	0.121	0.110	0.100	0.086	0.087	0.074	0.069	0.063	0.063	0.069	0.072	0.076
7. Net Interest	0.002	0.002	0.003	0.004	0.006	0.011	0.015	0.018	0.019	0.018	0.017	0.016	0.015
OTHER PRIVATE BUSINESS													
8. Rentl Inc+OPB In	0.030	0.033	0.033	0.029	0.020	0.010	0.003	0.005	0.005	0.005	0.003	0.003	0.005
9. Net Interest	0.010	0.014	0.021	0.024	0.026	0.031	0.041	0.042	0.046	0.047	0.049	0.050	0.051
10. Business&Capital Inc	0.313	0.290	0.266	0.277	0.224	0.225	0.213	0.216	0.201	0.216	0.229	0.229	0.234
11. Profits&Prop'trs Inc	0.303	0.275	0.243	0.247	0.179	0.169	0.136	0.133	0.112	0.129	0.143	0.144	0.148
12. Total Net Interest	0.011	0.015	0.023	0.031	0.044	0.056	0.077	0.083	0.090	0.087	0.086	0.086	0.086
13. Corporate-Total as % of Business & Cap. Income	0.399	0.411	0.371	0.434	0.380	0.383	0.377	0.381	0.339	0.383	0.396	0.386	0.368
14. Corporate-Total as % of Sole Prop & P'tnrship-Total	0.844	0.965	0.872	1.156	0.918	0.883	0.905	0.952	0.839	1.025	1.047	1.010	0.938
15. Corporate Profits as % of Proprietors' Income of Sole Prop & P'tnrships	0.870	0.993	0.896	1.185	0.850	0.829	0.796	0.860	0.701	0.970	1.015	0.967	0.879

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NOTE:

All incomes include IVA and CCA adjustments, as relevant.

Business and Capital Income = sum of corporate profits, net interest in the corporate sector; proprietor's income for sole proprietors and partnerships and net interest in that sector; proprietor's income from other private business, rental income, and net interest in that sector.

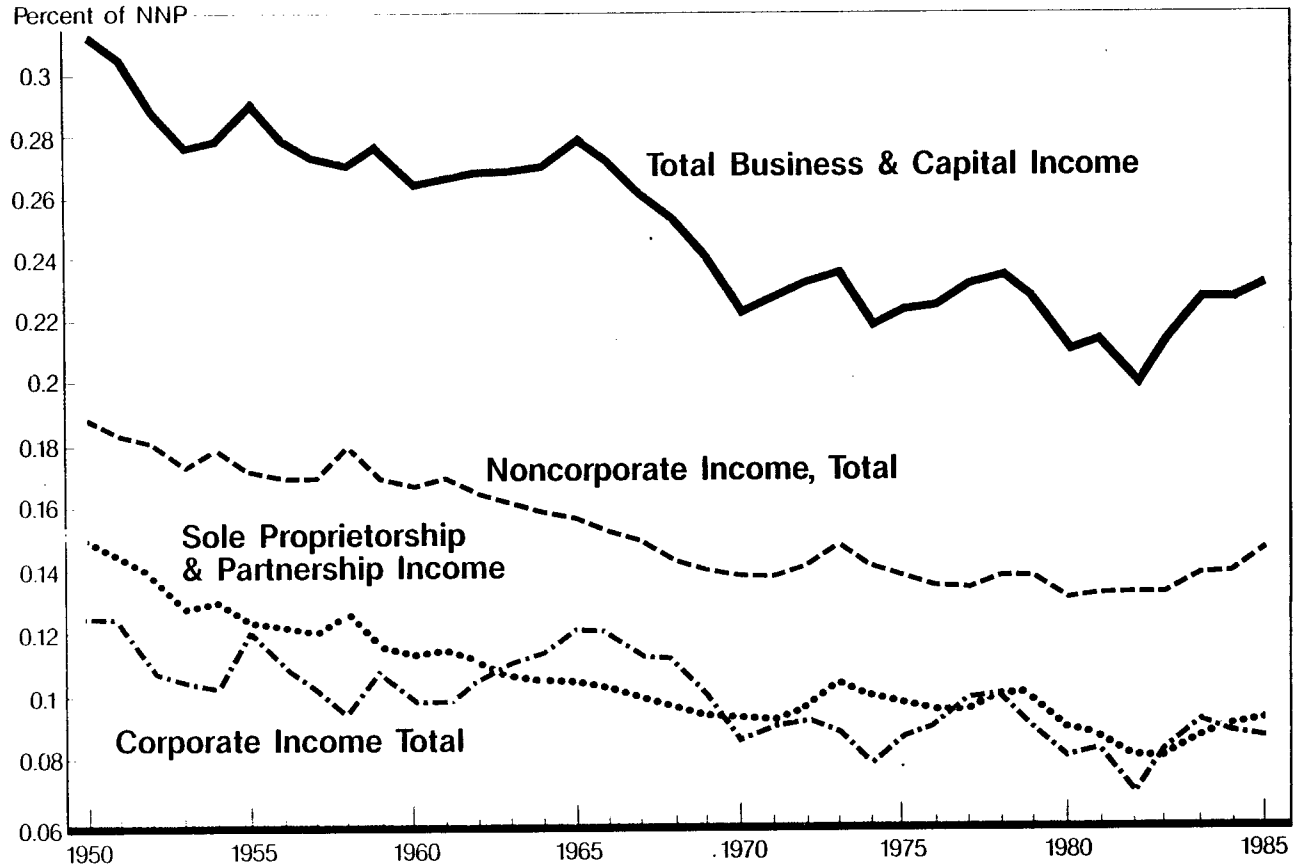
Profits & Proprietors' Income = sum of corporate profits, proprietors' income for sole proprietorships, partnerships, and other private business, and rental income.

Total Net Interest = sum of net interest of corporations, sole proprietorships, partnerships, and other private business.

Row 13 = Row 1/Row 10; Row 14 = Row 1/Row 5; Row 15 = Row 2/Row 6.

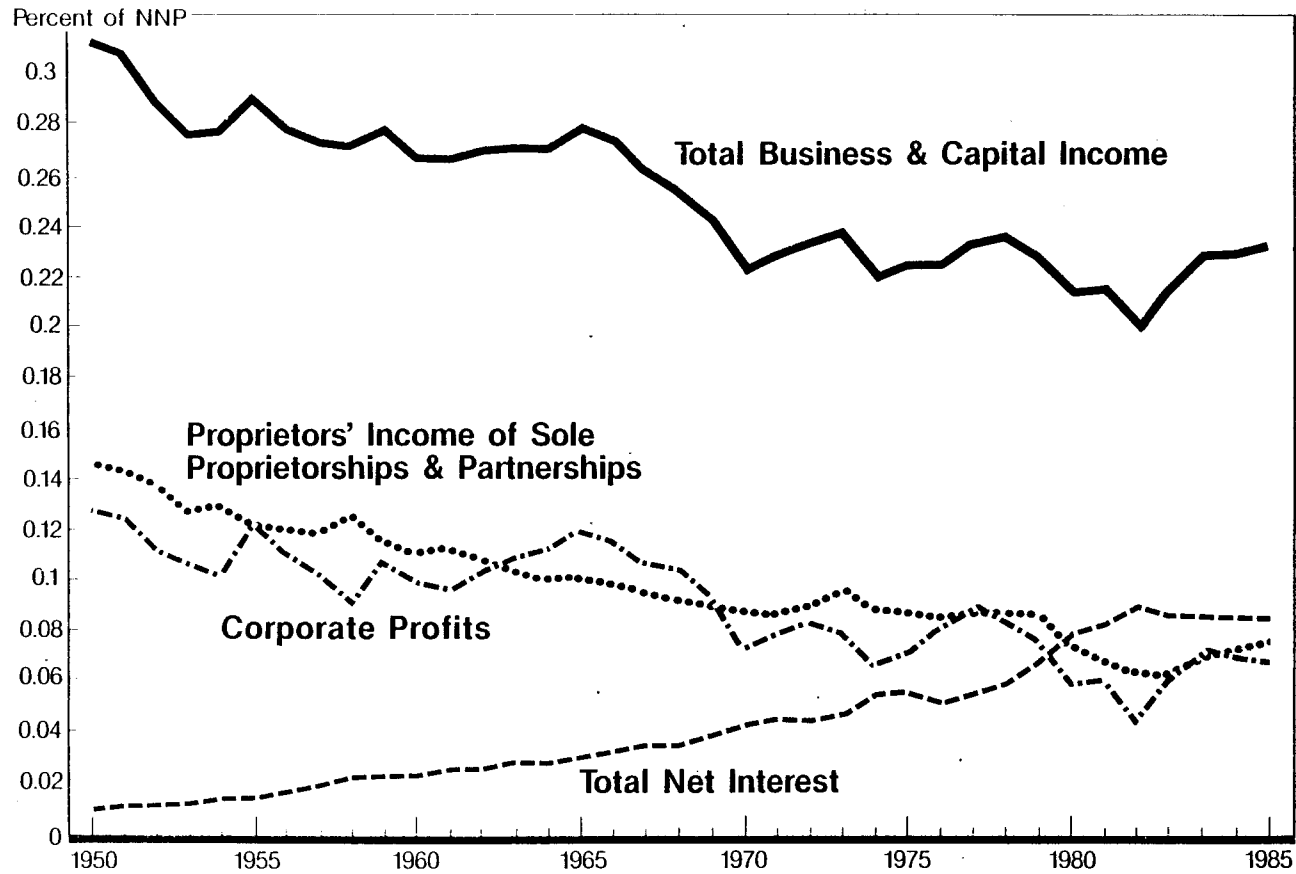
SOURCE: National Income and Product Accounts, Tables 1.9, 1.15, 1.16, 3.1, 8.8, and 8.9.

Graph 1
BUSINESS & CAPITAL INCOME
 As % of Net National Product



Source: Table 1.

Graph 2
PROFITS & PROPRIETOR'S INCOME
 As % of Net National Product



Source: Table 1.

borrowers.³ Net interest payments by the corporate sector, as well as by nonfinancial corporations alone, shot up between 1965 and 1970, and grew more slowly in the noncorporate sector.

Since 1982 and the trough of the recession, most of these trends seem to have stopped and in some cases have even been reversed, although four years provide too little experience to be certain. As a fraction of NNP, total income in the corporate sector and corporate profits have not only recovered from the recession but have returned to their ranges of the 1970's. While net interest in the corporate and noncorporate sectors is running higher than most of the 1970's, it no longer appears to be rising, relative to NNP. Proprietors' income from sole proprietorships and partnerships has been slower to bounce back from the recession, but it has been increasing steadily as a share of NNP.

Do these trends provide evidence of disincorporation, or a shift of economic activity from the corporate to the noncorporate sector, in recent years? The answer is no. As row 13 (third from the bottom) of Table 1 shows, income from the corporate sector has hovered around 40 percent of total income from business and capital in the private sector throughout this period. While corporate income varies relative to noncorporate income from year to year (corporate income is more cyclical than noncorporate income), there does not appear to be any persistent trend over time. This conclusion holds as well if corporate income is compared to income from the sole proprietorships and partnerships (row 14), or if corporate profits are compared to proprietors' income from partnerships and sole proprietorships (row 15). Income from business and capital has been shrinking over the past four decades relative to NNP but no faster in the corporate than in the noncorporate sector.

B. Trends in Income for Tax Purposes

Although the national income accounts show no shift from corporate to noncorporate activity, there could have been a shift between the sectors for tax purposes. The fall in corporate taxes relative to total budget receipts or national income that Auerbach and Poterba addressed is well known and contributed to congressional willingness during tax reform to pay for reductions in taxes on individuals by raising taxes on corporations. Whether taxes on income from noncorporate business have also fallen over the past several decades is not apparent and cannot be determined directly since taxes on noncorporate business are reported in combination with other taxes paid by the owners. Indirect evidence on changes in taxes on noncorporate business may come from looking first at the income reported on business tax returns, and secondly at the income from noncorporate business reported on individual income tax returns.

Table 2 presents income and losses reported on corporate and noncorporate tax returns for the past 15 years, and average annual rates of change in the

Table 2

NET INCOME AND LOSS AS REPORTED ON BUSINESS TAX RETURNS, BY TYPE OF RETURN, 1970-1985

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
(Amounts in Billions of Dollars)																
CORPORATE																
Net Inc less deficit	65.9	79.7	96.8	120.4	146.0	142.6	185.4	219.2	246.9	284.6	239.0	213.7	154.3	188.3	232.9	na
Net income	83.7	96.7	112.8	138.3	171.2	169.5	210.4	245.3	274.5	321.7	296.8	301.4	274.3	296.9	349.2	na
Deficit	17.8	17.0	16.0	17.9	25.2	26.8	25.0	26.0	27.7	37.0	57.8	89.8	120.0	108.6	116.3	na
SUB S CORPORATIONS																
Net income less deficit	1.9	2.2	2.9	3.7	3.6	3.2	3.7	4.8	5.3	3.8	2.5	1.9	3.0	5.1	6.9	na
Net income	3.0	3.4	4.2	5.2	5.7	5.5	6.2	7.6	8.6	8.6	8.1	8.5	11.0	14.6	18.7	na
Deficit	1.2	1.2	1.3	1.5	2.1	2.3	2.6	2.8	3.2	4.8	5.6	6.6	7.9	9.5	11.8	na
SOLE PROPRIETORSHIPS - NONFARM																
Net income less deficit	30.5	31.5	33.9	38.1	39.0	39.6	44.4	49.4	53.5	56.5	54.9	53.1	50.6	60.4	70.8	78.8
Net income	33.7	35.0	37.8	42.5	44.6	45.6	50.9	56.8	62.3	67.1	68.0	68.6	68.6	78.6	89.8	98.8
Deficit	3.2	3.5	3.9	4.5	5.3	6.0	6.5	7.4	8.8	10.6	13.1	15.5	18.1	18.3	19.1	20.0
PARTNERSHIPS																
Net Adj. Income less defi	11.8	11.3	12.2	12.0	12.2	11.1	15.2	16.8	19.1	20.8	16.4	7.6	4.8	8.9	9.9	7.1
Net inc-adj.	15.6	16.7	18.3	20.2	23.2	23.9	26.4	30.4	35.4	41.7	46.9	52.1	55.1	60.6	71.0	76.9
Deficit-adj	3.8	5.4	6.1	8.2	11.1	12.8	11.3	13.6	16.3	20.9	30.5	44.5	50.3	51.7	61.1	69.7
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Note: Adjusted partnership income or deficit = ordinary income + guaranteed payments to partners - income or loss from other partnerships.

(Continued on next page)

Table 2 -- Continued

AVERAGE ANNUAL RATES OF CHANGE OF INCOME AND LOSS REPORTED
ON BUSINESS TAX RETURNS, 1970-1984/85

	1970-75	1975-80	1980-84/85	1970-84/85
(Percentages)				
CORPORATE				
Net Inc less deficit	0.154	0.103	-0.006	0.090
Net income	0.141	0.112	0.041	0.102
Deficit	0.082	0.153	0.175	0.134
SUB S CORPORATIONS				
Net income less deficit	0.112	-0.050	0.252	0.094
Net income	0.119	0.077	0.210	0.130
Deficit	0.130	0.181	0.188	0.165
SOLE PROPRIETORSHIPS - NONFARM				
Net income less deficit	0.052	0.065	0.063	0.060
Net income	0.060	0.080	0.070	0.070
Deficit	0.125	0.156	0.095	0.128
PARTNERSHIPS				
Net Adj. Income less deficit	-0.012	0.078	-0.126	-0.013
Net inc-adj.	0.086	0.135	0.103	0.108
Deficit-adj	0.245	0.174	0.174	0.199

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Office of Tax Analysis

Source: IRS Statistics of Income for the relevant years.

income.⁴ These income measures are the starting point for taxpayers in determining the tax base at the corporate and individual levels. They reflect many of the provisions of the tax law pertaining to income measurement such as the depreciation schedules and accounting procedures used for tax purposes. For partnerships and Subchapter S corporations, however, they misstate income by excluding items of income and expense that are subject to different limitations or elections at the level of the individual partner or shareholder.⁵ Capital gains and tax preferences such as intangible drilling costs are the largest omissions.

The figures in Table 2 offer conflicting evidence on whether or not there has been a shift in income for tax purposes between the corporate and noncorporate sectors. Over the whole period from 1970 to 1985, growth in net income less deficit, and in net income alone, was as strong on corporate returns as on sole proprietor or partnership returns: net income less deficit grew at an average annual rate of 9.0 percent for corporate returns, but only 6.3 percent for sole proprietorships, and fell at a rate of 3.4 percent for partnerships. However, corporate income has been growing at a declining rate, while the noncorporate returns do not show such a trend.

Within the noncorporate sector, losses consistently grew faster than net income on all types of returns.⁶ Subchapter S corporations in the 1980's provided the only exception to this. With the increase from 25 to 35 in the allowable number of shareholders and other simplifications of the Subchapter S rules in 1982, a rapid growth in Subchapter S income is consistent with the expectation of profitable corporations shifting away from double taxation of corporate dividends when given the chance. On partnership returns, the rate of growth of losses actually slowed between the early 1970's and the 1980's, in spite of the boom in tax shelters in the late 1970's and early 1980's. Sole proprietorships were the slowest growing type of noncorporate business. Net income and deficit both had lower growth rates on proprietorship returns than on Subchapter S or partnership returns.

Since most noncorporate income is taxed at the individual level, income reported on individual returns is more directly related to the tax burden imposed on this form of income than is the income reported on the business return. Table 3 shows the net income, gains and losses from each type of noncorporate business as reported on individual income tax returns from 1970 to 1985, and the average annual rates of change in those measures. At the individual level, net income less deficit and income from noncorporate business have been growing more slowly than AGI. If the income distribution of these forms of income has not changed appreciably, this suggests that the taxes paid on noncorporate business income might have fallen relative to total individual income taxes.

Several interesting points emerge from comparing the noncorporate income and losses reported on individual returns and on the business returns (Table 4). First, a substantial amount of Subchapter S net income and deficit does not appear on the returns of individuals. Typically, individual returns

Table 3

INCOME AND LOSS FROM NONCORPORATE BUSINESS REPORTED ON INDIVIDUAL INCOME TAX RETURNS, 1970-1985

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
(Amounts in Billions of Dollars)																
AGI	632	674	746	8270	906	948	1054	1159	1302	1465	1614	1773	1852	1943	2140	2322
Sole Prop.-Net	30.6	32.0	34.5	38.1	42.0	39.4	44.5	49.5	53.5	56.6	55.1	53.1	50.6	60.4	70.0	78.8
Net Gain	33.5	35.3	38.1	42.2	46.9	44.9	50.3	56.1	61.4	66.0	67.0	68.5	68.6	78.6	89.8	98.8
Net Loss	3.0	3.3	3.7	4.1	4.8	5.4	5.8	6.6	7.9	9.5	11.9	15.5	18.1	18.3	19.1	20.0
Partnership-Net	10.9	10.8	11.1	11.2	11.0	10.8	11.7	13.3	15.0	12.4	9.4	-0.1	-0.9	-2.5	-8.4	-8.6
Net Gain	13.7	14.2	15.3	16.8	17.9	18.4	19.7	21.4	24.3	24.2	25.6	25.9	27.4	29.6	30.5	34.9
Net Loss	2.8	3.4	4.2	5.6	6.9	7.6	8.0	8.0	9.2	11.8	16.2	26.0	28.3	32.1	39.0	43.5
Sub S. - Net	1.7	2.0	2.1	2.1	2.6	2.1	1.9	2.0	2.3	2.2	0.7	-0.8	-0.8	2.0	6.2	6.4
Net Gain	2.6	2.9	3.1	3.4	3.9	3.8	4.1	4.2	5.0	5.3	4.5	4.3	5.6	9.1	15.1	16.8
Net Loss	0.8	0.9	1.0	1.3	1.3	1.7	2.2	2.2	2.7	3.0	3.9	5.1	6.4	7.1	8.9	10.4
Rental - Net	2.4	2.6	3.0	3.8	3.8	3.4	3.9	3.0	3.1	1.8	0.2	-2.8	-8.5	-11.2	-16.0	-19.8
Net Gain	4.9	5.3	6.1	7.2	8.0	8.1	9.1	9.3	11.0	12.0	13.7	15.1	13.7	14.7	15.4	16.3
Net Loss	2.5	2.7	3.1	3.5	4.2	4.6	5.2	6.3	7.8	10.2	13.5	17.8	22.2	25.9	31.4	36.2

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Note: Income from partnerships and Subchapter S corporations reported on business returns differs from the income reported on individual returns. See discussion in the text.

(Continued on next page)

Table 3 -- Continued

AVERAGE ANNUAL RATES OF CHANGE IN INCOME AND LOSS FROM NONCORPORATE BUSINESS REPORTED ON INDIVIDUAL INCOME TAX RETURNS,
1970 - 1985

	1970-75	1975-80	1980-84/85	1970-84/85
	(Percentages)			
AGI	0.068	0.106	0.073	0.082
Sole Prop - net	0.041	0.067	0.071	0.060
Net Gain	0.048	0.080	0.078	0.069
Net Loss	0.101	0.156	0.104	0.120
Partnership - net	-0.001	-0.026		
Net Gain	0.052	0.067	0.062	0.060
Net Loss	0.164	0.151	0.198	0.171
Sub S - net	0.003	-0.224	0.452	0.077
Net Gain	0.052	0.037	0.262	0.117
Net Loss	0.134	0.163	0.197	0.165
Rental - net	0.054	-0.568		
Net Gain	0.082	0.106	0.036	0.074
Net Loss	0.105	0.214	0.198	0.172

Department of the Treasury
Office of Tax Analysis

SOURCE: Relevant issues of IRS Statistics of Income, Business Income Tax Returns, Partnership Returns, Corporate Income Tax Returns, Sole Proprietorship Returns, or SOI Bulletins.

Table 4

INCOME FROM NONCORPORATE BUSINESS REPORTED ON INDIVIDUAL RETURNS AS A PERCENTAGE OF INCOME REPORTED ON THE BUSINESS RETURNS, 1970-1985

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
	(Percentages)															
SUB S CORPORATIONS																
Net income-deficit	93.9	93.8	73.5	58.2	72.6	63.5	51.1	41.5	42.7	58.8	26.6	-43.7	-27.9	39.4	89.3	na
Net income	85.1	86.2	74.8	65.3	69.0	68.6	65.0	55.3	58.5	61.2	56.1	50.3	50.8	62.4	80.5	na
Deficit	71.3	72.6	77.8	82.3	63.1	75.8	85.0	78.4	84.5	63.1	69.4	77.1	80.9	74.8	75.4	na
SOLE PROPRIETORSHIPS - NONFARM																
Net income-deficit	100.1	101.6	101.7	100.1	107.8	99.5	100.2	100.0	100.1	100.1	100.3	100.0	100.0	100.0	100.0	100.0
Net income	99.4	101.0	100.9	99.1	105.0	98.3	98.9	98.7	98.6	98.4	98.5	100.0	100.0	100.0	100.0	100.0
Deficit	93.5	95.0	94.6	90.9	90.4	90.8	90.0	89.7	89.5	89.6	90.8	99.9	99.9	100.0	100.0	100.0
PARTNERSHIPS																
Adj. Net Inc-Def.*	92.2	95.7	91.0	92.8	90.5	96.5	77.0	79.3	78.9	59.8	57.4	-1.8	-18.8	-28.4	-85.2	-120.1
Adj. Net Income*	88.2	85.0	83.4	83.0	77.1	76.6	74.4	70.4	68.6	58.2	54.6	49.7	49.6	48.9	43.0	45.5
Adj. Net Deficit*	75.6	62.6	68.4	68.6	62.5	59.4	70.9	59.4	56.6	56.5	53.1	58.5	56.2	62.2	63.8	62.4

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SOURCE: Tables 2 & 3.

* Adjusted partnership income or deficit = ordinary income + guaranteed payments to partners - income or loss from other partnerships.

show only 60 to 70 percent of net income and 70 to 80 percent of the deficits, even though individuals are practically the only taxpayers allowed to own shares of Subchapter S corporations. Several factors might contribute to the "missing" gains and losses. (1) Some of the income goes to estates and trusts, which can also own Subchapter S stock. Based on data for 1982, the most recent available, estates and trusts might explain almost 40 percent of the \$3.8 billion difference in Subchapter S net income less deficit reported on individual returns and on the corporate returns.⁷ (2) Some items of income and expense that are separately treated at the shareholder level and are included in ordinary income of the owner are not included in income on the Subchapter S return, though these are probably small. (3) Gains on individual returns refer to the net amount on returns where gains exceed losses, whereas gains on the Subchapter S returns are the sum for corporations with net income (and similarly for losses). If this were the cause of the difference, net income less deficit would be (approximately) the same for individuals as for Subchapter S returns, but they are not. Furthermore, data in years when both total and net gains (and losses) have been reported still indicate a substantial, though smaller, amount of "missing" gains and losses. (4) Some income might go to nontaxable individuals, but this too is likely to be small. (5) Another possible explanation is simple underreporting at the individual level, but individuals have no incentive to avoid reporting losses.

A second difference between income reported on the business and individual returns applies to partnerships. Not only does less than 100 percent of the income and loss from partnership returns appear on individual returns, the fractions of income and net income less deficit have been generally decreasing since 1970, according to Table 4. In 1970, 88 percent of partnership net income was reported on individual returns, but only 45 percent in 1985. For the years when data are available, the decline in the ratio of total partnership income at the individual level to gains reported on partnership returns is just as pronounced as the ratio using net partnership income of individuals. This suggests that a shrinking fraction of partnership income is being taxed at the individual level. Where the other income has gone is unclear. There might be increased underreporting, or increased importance of separately treated items. A further and likely possibility is that partners other than individuals have come to receive an increasing share of partnership income and losses.

C. Partnership Income by Type of Partner

Unfortunately, few data are available on the distribution of partnership-level income and losses among different types of partners, and no data exist on changes over time. The Statistics of Income Division of the Internal Revenue Service conducted a study of the Schedules K and K-1's accompanying 1983 partnership returns.⁸ This study suggests that income and loss going to partners other than individuals explains much of the difference

between partnership income appearing on individual returns and on partnership returns. The study has several drawbacks that limit the reliability and universality of its results, however. The primary limitation is that the study was based only on partnership returns with 50 or fewer partners because the task of manually coding every K-1 for larger partnerships would have been enormous. In addition, information on the K-1's of about 10 percent of the returns with 50 or fewer partners was inconsistent with information on the Schedule K, and the partnership had to be excluded from the study. In the end, the sample of returns studied represented over half of the partners and nearly 90 percent of the partnerships. Although it must be used with some caution, SOI's K/K-1 study offers the only source of information on the distribution of partnership income among partners.

Table 5 (and Graph 3) summarize data from the K/K-1 study on the income and losses going to different types of partners.⁹ Partnerships are classified by net income or loss and by industry. The table indicates that in 1983, individuals received 62 percent of the unadjusted partnership gains in firms with 50 or fewer partners, and 54 percent of the unadjusted partnership losses in those firms. These figures are generally consistent with the percentages that partnership gains and losses on individual returns represent of the gains and losses reported on partnership returns in 1983. (Data from the 1983 individual and partnership Statistics of Income show that total partnership gains (without netting of losses) on individual returns represent 60 percent of total gains reported on partnership returns, while the comparable figure for losses is 61 percent.)

This consistency suggests that at least in 1983 much of the difference between the gains and losses shown on partnership returns and the partnership income reported on individual returns probably can be explained by income going to other partners, rather than by underreporting or separately treated items of income and expense that would only appear at the individual level. Whether income going to other partners has increased over time and can explain the decreasing share of partnership income that appears on individual returns cannot be determined from one year's data.

The importance of other types of partners varies considerably among industries, and to some extent between gain and loss partnerships. Overall (among partnerships with 50 or fewer partners), corporations received 22.5 percent of income from gain partnerships and 26 percent of losses from loss partnerships in 1983. This ranges from a high of over 70 percent of income in the transportation, communication, electric, etc. industry, to about 40 percent of income from mining, to a low of less than 10 percent of gains and losses in agriculture. The role of partnerships as partners also varies substantially. Partnerships appear most prominently in mining, where they received 22 percent of the unadjusted gains and 18 percent of the losses, and in real estate, where they accounted for 12 percent of gains and 19 percent of losses. Except in mining, they received larger shares of losses than of

Table 5

PARTNERS' SHARE OF GAINS AND LOSS, BY TYPE OF PARTNER AND INDUSTRY, 1983

Industry:	PARTNERSHIPS WITH GAINS ¹						PARTNERSHIPS WITH LOSSES ¹					
	All ²	Agri- culture	Mining	Trans- portation	Real Estate	Services	All ²	Agri- culture	Mining	Transpor- tation	Real Estate	Services
(Percentages)												
All Sizes ³	59972.5	2620.8	6392.8	1127.9	22562.7	20130.0	-62638.3	-2794.3	-10278.5	-1831.5	-35636.2	-7995.2
>50 Partners	7251.8	26.2	1050.1	13.5	3142.9	2947	-6509.4	-155.3	-1468.5	-136.9	-3526.4	-1025.0
<50 Partners	46326.4	2443.7	4385	1075.1	16995.9	14910	-47637.2	-2339.2	-7657.2	-1512.7	-27078.8	-5592.9
Partnerships with <50 Partners:												
All Partners	46326.4	2443.7	4385	1075.1	16995.9	14910	-47637.2	-2339.2	-7657.2	-1512.7	-27078.8	-5592.9
Corporations	10410.4	128.9	1718	757.9	2966.8	2971	-12397.1	-204.3	-3378.8	-1105.8	-4525.6	-1741.1
Individuals	28887.2	2022.5	1379.7	275.2	10366.5	10852	-25800.1	-1851.7	-2691.2	-281.5	-16252.9	-2948.8
Partnerships	3650.6	40.7	979.5	20.9	2024.1	327	-7694.1	-126.8	-1409.2	-96.9	-5168.3	-733.9
Fiduciaries	1747.7	77.5	244.5	8.2	1191.6	141	-891.8	-48.9	-113.0	-8.6	-639.8	-61.1
Other	1381.4	166.8	46.1	12.7	362.8	537	-565.1	-75.6	-48.3	-18.9	-282.6	-91.9
Unknown	249.1	7.3	17.1	0.3	84.1	79	-289.1	-31.8	-16.7	-0.9	-209.6	-15.9

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(Continued on next page)

Table 5 -- Continued

PERCENTAGE DISTRIBUTION OF PARTNERSHIP GAINS AND LOSSES, BY TYPE OF PARTNER, 1983

Industry:	PARTNERSHIPS WITH GAINS ¹						PARTNERSHIPS WITH LOSSES ¹					
	All ²	Agri- culture	Mining	Trans- portation	Real Estate	Services	All ²	Agri- culture	Mining	Transpor- tation	Real Estate	Services
(Percentages)												
All Sizes ³	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
>50 Partners	0.121	0.010	0.164	0.012	0.139	0.146	0.104	0.056	0.143	0.075	0.104	0.128
<50 Partners	0.772	0.932	0.686	0.953	0.753	0.741	0.761	0.837	0.745	0.826	0.761	0.700
Partnerships with <50 Partners:												
All Partners	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
Corporations	0.225	0.053	0.392	0.705	0.175	0.199	0.260	0.087	0.441	0.731	0.260	0.311
Individuals	0.624	0.828	0.315	0.256	0.610	0.728	0.542	0.792	0.351	0.186	0.542	0.527
Partnerships	0.079	0.017	0.223	0.019	0.119	0.022	0.162	0.054	0.184	0.064	0.162	0.131
Fiduciaries	0.038	0.032	0.056	0.008	0.070	0.009	0.019	0.021	0.015	0.006	0.019	0.011
Other	0.030	0.068	0.011	0.012	0.021	0.036	0.012	0.032	0.006	0.012	0.012	0.016
Unknown	0.005	0.003	0.004	0.000	0.005	0.005	0.006	0.014	0.002	0.001	0.006	0.003

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¹Gains and losses refer to ordinary income. Unlike Table 2, no adjustments are made here for guaranteed payments to partners or income from other partnerships.

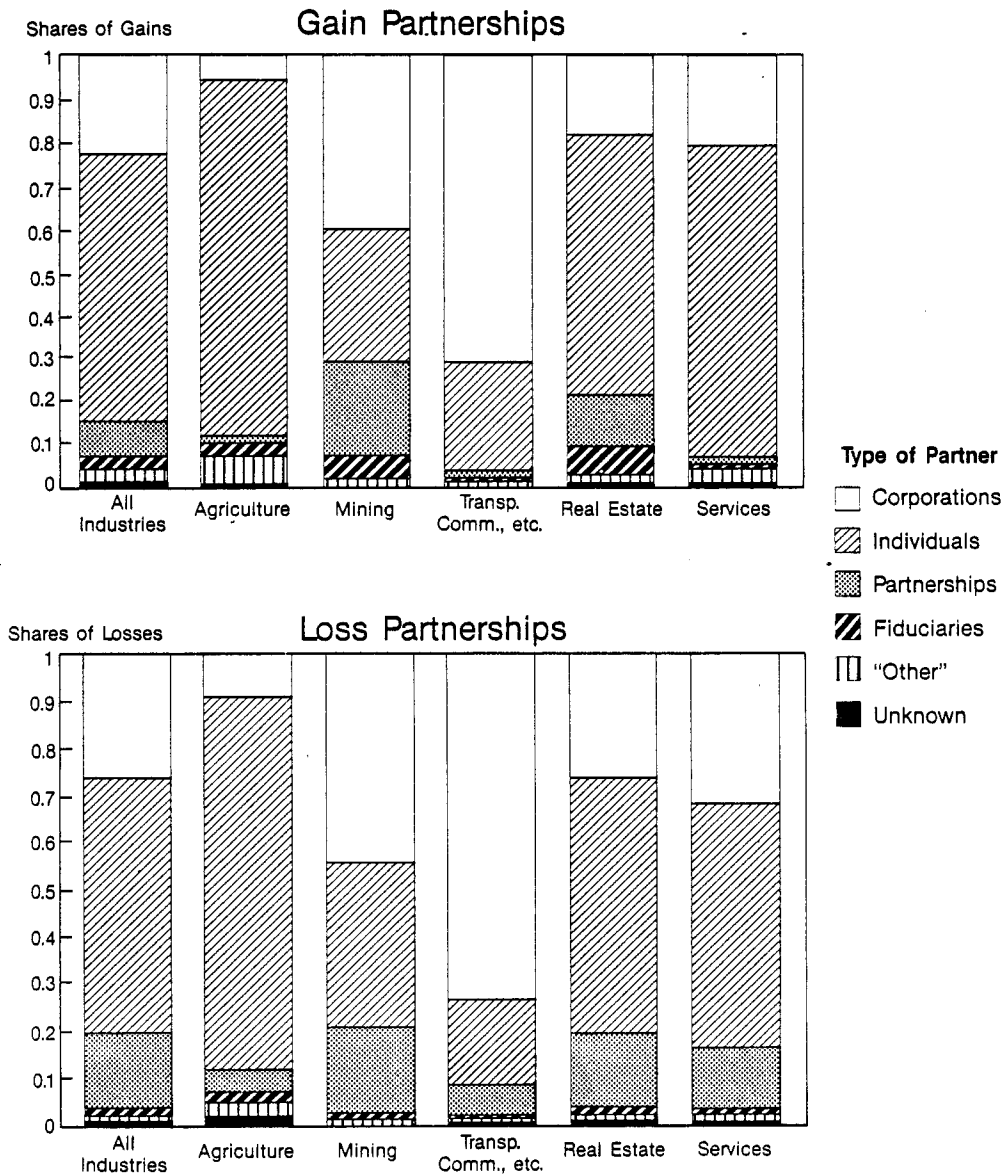
²"All" includes industries not separately shown.

³All sizes includes returns with 50 or fewer partners for which the sum of K-1's present appeared inconsistent with the Form 1065 information.

SOURCE: IRS Statistics of Income special study of K and K-1 forms from 1983 partnership returns.

Graph 3

INCOME SHARES BY TYPE OF PARTNER, 1983



NOTE: Shares apply to partners in partnerships with fewer than 50 partners in 1983.

Source: Table 5.

gains. Fiduciaries and "other" types of partners (which includes tax-exempt institutions, cooperatives, nominees) received small shares of partnership income, and typically more of the gains than of the losses.

D. Master Limited Partnerships

Large partnerships whose shares are traded on organized exchanges, commonly referred to as master limited partnerships (MLP's), have one foot in both the corporate and noncorporate sectors. Structured and taxed like partnerships, with all income and expenses flowing through to the partners, to many observers they have the characteristics of corporations: free transferability of interests, continuity of life, and centralization of management. Since the first MLP was organized in 1982, they have grown rapidly until they number well over 100 now. Through 1985, MLP's were confined to the oil and gas, real estate, and timber industries. Since that time, they have been appearing in a wide range of industries, including restaurants, professional sports teams, and movies.

This growth in numbers and expansion in activities generated concern at the Treasury Department and in Congress that continued rapid growth of MLP's could seriously erode the corporate tax base, and led Congress in 1987 to enact several provisions that would restrain future growth in MLP's and other "publicly traded" partnerships. Specifically, the 1987 legislation would tax as a corporation essentially any newly formed MLP unless it operated in the real estate or natural resource industries, or received the bulk of its income from other "passive-type" activities.¹⁰ All MLP's existing when the legislation was enacted would continue to be taxed as partnerships until 1998. In addition, the legislation declares that net income from MLP's and the other publicly traded partnerships, with no "grandfathering," is deemed to be portfolio income for the purposes of passive loss limitations, and therefore cannot offset tax shelter losses.

Table 6 documents some of the major differences between MLP's and limited partnerships in general in 1985. Based on tax returns for nearly three-quarters of the MLP's in existence in 1985 and on SOI data on limited partnerships, Table 6 presents average financial statistics for limited partnerships and for MLP's, categorized by industry and gain or loss in ordinary income. The most striking difference, of course, is that the average MLP, with over 8,000 partners and \$300 million in assets, is much larger than the average limited partnership with only 28 partners and \$2.3 million in assets (Columns 2 and 5). The gain or loss in ordinary income is also much larger for MLP's, averaging \$21 million in gain and \$5 million in loss, compared to an average of \$200,000 in gain and \$300,000 in loss for all limited partnerships. While MLP's also showed larger amounts of debt--\$38 million on average, compared to \$2 million on average for all limited partnerships (Column 6)--MLP's had much smaller debt/equity ratios (Column 7). The 1985 ratio of debt to partners' capital accounts for MLP's of

Table 6

AVERAGE FINANCIAL STATISTICS FOR MASTER LIMITED PARTNERSHIPS 1/
AND ALL LIMITED PARTNERSHIPS, 1985

TYPE OF PARTNERSHIP 2/	NUMBER OF RETURNS	AVERAGE NUMBER OF PARTNERS	ORDINARY INCOME 3/	INCOME TO PARTNERS 4/	ASSETS	DEBT	DEBT/ EQUITY
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	(-----Dollar Amounts in Millions-----)						(Ratio)
MASTER LIMITED PARTNERSHIPS							
All Industries	34	8042	15.2	7.4	304.9	38.3	0.144
Gain MLPs	27	9052	21.5	9.1	345.6	40.1	0.131
Loss MLPs	7	3396	-5.2	1.8	172.9	32.6	0.233
Oil & Gas	21	9906	22.1	5.1	373.3	41.7	0.126
Gain MLPs	17	10480	30.1	9.5	478.7	52.1	0.122
Loss MLPs	4	6169	-3.7	-9.2	35.9	8.4	0.306
Real Estate & Timber	13	5892	4.0	11.2	194.5	33.0	0.204
Gain MLPs	10	7196	7.6	8.5	132.5	21.0	0.188
Loss MLPs	3	1547	-7.9	20.2	401.1	73.0	0.222
ALL LIMITED PARTNERSHIPS							
All Industries	279878	28	-0.1	na	2.3	2.0	7.819
Gain LPs	107229	34	0.2	na	2.0	1.4	2.395
Loss LPs	172649	25	-0.3	na	2.5	2.4	45.150

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- 1/ Of the 48 exchange-traded MLPs in existence in 1985, tax information was readily available for 34. Of these, 27 had positive ordinary income, 7 had losses.
- 2/ Partnerships with gain or loss in ordinary income.
- 3/ Ordinary income as reported on the Form 1065 Partnership return. This excludes certain types of income and expense, such as capital gains and intangible drilling costs which are reported on accompanying schedules.
- 4/ Income to partners equals ordinary income plus capital gains minus expenses, such as intangible drilling costs, oil & gas depletion, and specially allocated items.

SOURCE: Partnership tax returns for 1985, and IRS Statistics of Income, "Partnership Returns, 1985."

.144 was well below the average of 7.819 for all limited partnerships (and even below the .738 ratio for nonfinancial corporations that year). This ratio is lowered somewhat by equity-only MLP's that receive virtually all their income from other partnerships, which incur some debt. Even when these MLP's are excluded, the debt/equity ratio remains well below .5.

The MLP tax return data also illustrate the point made earlier in this paper that ordinary income is frequently not a good measure of the income from a partnership that is reported on partners' tax returns because it omits important flow-through items. From examining actual MLP returns, it was possible to calculate the income that actually went to the partners. Column 4 shows that "Income to Partners," ordinary income adjusted for separately stated items, was substantially less than the Form 1065 ordinary income for MLP's in the oil and gas industry, because of intangible drilling costs and depletion allowances. Seventeen MLP's in oil and gas had positive ordinary income but only nine had positive income to partners. (Several of the oil and gas MLP's were registered as tax shelters.) In real estate and timber, income to partners exceeded ordinary income because of capital gains. Three MLP's had losses in ordinary income, but only one had negative income to partners.

III. NONCORPORATE BUSINESS AFTER THE TAX REFORM ACT OF 1986

The Tax Reform Act raised taxes on business by expanding the definition of income subject to tax and eliminating or reducing tax credits for certain activities. At the same time it lowered taxes by reducing the corporate and individual tax rates applied to most of that income.

In general, provisions of TRA that changed the definition of business income subject to tax and that altered tax credits available to business made no distinction between corporate and noncorporate activities, though some changes of course had more impact on one sector than the other. Major examples of base broadening that applied across the board are the modifications to the accelerated cost recovery system, elimination of the investment tax credit, reduced deductions for business meals and entertainment expenses, uniform cost capitalization rules, and repeal of bad debt reserves. One base-broadener applicable only to pass-through entities and similar firms that are subject to the corporate income tax (personal service corporations) is the requirement that the fiscal years of these entities correspond to the taxable years of their major partners or owners.¹¹ At the individual level, the passive loss limitations, changes in the minimum tax, and elimination of the 60 percent exclusion for long-term capital gains broadened the tax base of income from business and capital.

The remainder of this section examines three major effects that these changes from TRA will have on business: (1) They will increase the taxes paid by corporate and noncorporate business. (2) They will alter the incentives to

invest in the corporate relative to the noncorporate sector. (3) They will lower the marginal tax rates paid on income from noncorporate business.

A. Revenue

Table 7 shows the five-year revenue effects on corporations and individuals of the major provisions that broadened the base of business income taxes. Overall, changes in the measure of business income subject to tax and allowable tax credits will raise corporate taxes by \$250 billion from FY 1987 through 1991. (Some of these provisions, notably many of the changes in accounting and depreciation, reflect changes in the timing of tax liabilities more than in the long-term level of taxes, however.) A reduction in tax rates from a maximum of 46 percent to 34 percent offsets \$119 billion of the base broadening, for a net increase in corporate taxes of \$131 billion. This amounts to a 29 percent increase compared to the five-year level of corporate taxes that would have been expected without TRA.

For individuals, Table 7 shows a five-year tax increase from base broadening on business income of \$68 billion. The benefit of individual rate reduction on this income is more difficult to calculate. Preliminary estimates from the Treasury Department's Individual Income Tax Model suggest that reducing rates lowers taxes on income from noncorporate business by about \$25 to \$30 billion over the five years.¹² This amount offsets about 40 percent of the \$68 billion tax increase from broadening the base, for a net tax increase of about \$40 billion on individual income from noncorporate business. Compared to the taxes that would have been expected on this income in the absence of TRA, this represents a 60 percent increase.

An alternative perspective on the tax changes for individuals might view the passive loss rules of TRA more as a tax increase on the income being sheltered (generally wage and salary income) than on income from noncorporate business. Taking this approach and excluding the tax shelter provisions from the Table 7's estimate of base broadening would lower the 60 percent increase to a 15-20 percent increase in individual taxes on income from noncorporate business, lower than the 29 percent increase calculated earlier for corporations.

Several qualifications need to be kept in mind in interpreting the estimate of the effect of rate reduction on income from noncorporate business. First, in this amount the rate cuts are "stacked first," that is, calculated before any other changes from TRA have been made. Stacking the rate cuts first is the way that Treasury and the Joint Committee on Taxation usually present the effects of separate tax reform provisions. Stacking the rate cuts first also means that the estimates do not include changes in incomes that would come in response to TRA provisions, and thus may understate the amount of rate reduction. Second, these estimates of the effect of rate cuts do not include the effect of eliminating the capital gains exclusion since many of these gains are from sales of corporate shares and other noncorporate business

Table 7

REVENUE EFFECTS OF BUSINESS PROVISIONS OF THE TAX REFORM
ACT OF 1986, BY CORPORATE AND INDIVIDUAL TAXPAYERS
(FY 1987-1991)

Provisions of TRA	INDIVIDUAL	CORPORATE
	(in Billions of Dollars)	
Repeal of ITC	27.3	123.2
Modify ACRS	-0.2	2.4
Accounting	5.9	57.5
Minimum tax	4.1	19.9
Insurance products and companies	0.0	11.9
Foreign tax provisions	0.2	10.5
Expenses for business and entertainment	3.3	7.8
Financial institutions	0.0	7.2
Repeal General Utilities	-6.4	6.1
Corporate capital gains	0.0	5.0
General business and corporate	1.0	3.0
Tax-exempt bonds	3.7	1.9
Compliance - business	0.0	1.8
Energy, agriculture, natural resource, timber	1.0	0.6
Self-employed health premiums	-0.8	0.0
Miscellaneous credits + R&D	-1.0	-3.7
Tax shelters	29.6	-4.0
SUBTOTAL, Base-broadening	67.7	251.1
Rate Reductions	25-30	119
Net Change:		
With shelter provisions	38-43	131
Without shelter provisions	9-14	131

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SOURCE: Mid-session Review Revenue Estimates of the Tax Reform Act of 1986, Office of Tax Analysis, Treasury Department, July 10, 1987.

sales. Treasury estimates this as raising \$31 billion in revenue from FY 1987-91, with most of that coming in FY 1987 due to accelerated realizations before the exclusion was ended.

B. Incentives

TRA will affect the growth of the noncorporate sector by altering the relative attractiveness of investment in corporate and noncorporate business. The difference in total effective tax rates on income in the two sectors is an important indication of the incentive to invest in one sector over the other. Economists disagree, however, on how to measure these tax rates, and the answer to whether TRA made noncorporate investment more or less attractive than it was before, relative to corporate investment, depends on the approach selected.¹³ Three factors that particularly influence the comparison of effective tax rates are (1) the ratio of debt to equity in the financing of the investment, (2) the "view" of dividends chosen, and (3) the asset mix used in the calculations.

1. Debt/Equity. For equity-financed investments, the disadvantage of the corporate sector caused by the double taxation of dividends is well known. By lowering both corporate and individual tax rates, TRA tended to reduce this disadvantage.

For debt-financed investments, interest deductibility means that such investments face only one level of tax in both sectors. The higher statutory tax rate in the corporate sector means that the value of tax depreciation allowances are larger for a corporation than a noncorporate firm. Consequently, debt-financed investment in depreciable property is tax favored in the corporate sector relative to the noncorporate sector. By lowering tax rates overall and reducing differentials among tax rates on alternative investments, the Tax Reform Act reduced the advantage of the corporate sector for debt-financed investment.

2. The "View" of Dividends. To the extent that corporate investment is financed with equity, the return would come to the stockholder as either dividends or capital gains. The "old view" of dividends taxation says that taxes on both dividends and capital gains affect the after-tax return on equity. The "new view" implies that taxes on dividends have been capitalized in the value of the equity and therefore do not burden the return to new equity. The capital gains tax is then the relevant tax on equity-financed investment. Since TRA raised capital gains taxes but lowered taxes on dividends, corporate taxes would tend to increase more under the new than the old view of dividends taxation.

3. Asset Mix. The types of assets making up the capital stock and investment in the corporate sector differ from the noncorporate sector. In

particular, a larger fraction of corporate than noncorporate investment is in equipment, which was the type of investment on which TRA raised taxes the most. Consequently, estimates of the effective tax rates for the corporate and noncorporate sectors as a whole would tend to show larger increases in the corporate rate, whereas asset by asset the differences would be smaller. Whether changes in effective taxes should be compared asset by asset or over all capital in the sector depends in part on the question being asked. The asset by asset approach is useful for determining how TRA changed the attractiveness of the two sectors for a given investment. Comparing changes in overall rates might suggest how the growth in overall investment will shift between the sectors. Since investment in equipment will become less attractive relative to other types of investment, TRA may tend to shift total investment out of the corporate sector and into noncorporate business.

Fullerton, Gillette, and Mackie (FGM) estimate the effects of these various factors.¹⁴ Like most economists, they find that, before TRA, effective tax rates on income from corporate investments generally exceeded taxes on noncorporate income, except for fully debt-financed projects. FGM also conclude that TRA consistently raised effective tax rates in both the corporate and noncorporate sectors for investment in equipment and structures, and frequently lowered it for inventories and land. With TRA, the tax advantage to the corporate sector for fully debt-financed investments persists but is substantially reduced, overall and on an asset-by-asset basis. For investments that are financed by equity, in whole or in part, the overall tax advantage remains with the noncorporate sector but rises or falls slightly depending on the assumptions. On an asset-by-asset basis, however, TRA reduces the tax advantage of the noncorporate sector under most assumptions for equity investments.

The FGM results generally support the conclusion that TRA "leveled the playing field" by narrowing differentials in effective tax rates between corporate and noncorporate sectors, given the type of financing. In addition, FGM's findings suggest that the Tax Reform Act may have reduced the attractiveness in many circumstances of setting up businesses as MLP's, which tend to be heavily financed by equity, instead of as corporations.

C. Marginal Rates

At the individual level, major changes in the taxation of income from noncorporate business resulted from Tax Reform's lower marginal tax rates for individuals and limitations on passive losses (including minimum tax treatment of allowed passive losses). Some implications of these changes can be drawn from examining effective individual marginal tax rates, before and after TRA, on income from noncorporate business. The top half of Table 8 presents, by type of business and by gain or loss, the average marginal rates that would

Table 8

MARGINAL TAX RATES ON NONCORPORATE INCOME OF INDIVIDUALS
BEFORE AND AFTER TRA, BY TYPE OF BUSINESS
(1988 LEVELS OF INCOME)

Pre-TRA Law	Type of Income or Loss		
	Total	Gains	Losses
Sole Proprietor	26.5	28.7	16.4
Rental	22.7	30.9	19.0
Subchapter S	31.9	43.6	13.8
Partnership	31.0	33.4	28.9

Post-TRA Law	Total	Net Gains		Net Losses	
		Active	Passive	Active	Passive
Sole Proprietor	21.6	23.3	na	13.7	na
Rental	20.2	na	22.8	na	19.2
Subchapter S	19.4	27.7	27.0	15.8	5.5
Partnership	17.1	25.2	23.6	22.2	9.0

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na = not applicable.

Note: Average effective marginal rates are calculated by increasing the income on each return by 1 percent of the absolute value of the relevant type of income.

SOURCE: Special analyses from the Individual Income Tax Model, Office of Tax Analysis, U.S. Department of the Treasury.

have prevailed in 1988 if pre-TRA law had continued, and the bottom half of the table presents marginal rates expected under TRA for that year. These rates were calculated using the Treasury Department's Individual Income Tax Model. Taxpayers were classified as having gains or losses, and passive or active gains or losses, according to their net income from a particular type of business.

The marginal rates in Table 8 reflect most of the provisions of pre- and post-TRA law that apply to individuals in 1988, including minimum tax and passive loss rules, but the rates estimated do not capture intertemporal effects of the provisions. For example, they do not include the value of tax credits for minimum taxes previously paid on allowed passive losses. They do not reflect the present value of currently disallowed (deferred) passive losses that will be allowed in the future, nor do they capture the fact that the real cost of most of the minimum tax provisions is a prepayment of taxes. Ideally, the marginal tax rates should include an estimate of the present value of these intertemporal aspects. In practice, taxpayers probably attach a large and varied degree of uncertainty to the value of future taxes or tax savings, making any choice of discount rate difficult. In addition, the available data were ill-suited for estimating the intertemporal components of the marginal rate. Consequently, the figures in Table 8 reflect changes in 1988 taxes that taxpayers would see with a change in 1988 income or loss.

The pre-TRA rates show several interesting characteristics of taxpayers receiving income from noncorporate businesses. The disparity in rates among taxpayers with different types of income indicates different amounts of total income: taxpayers with net losses had lower marginal rates than taxpayers with net gains from the same type of business, either because the losses were large enough to bring down their total income or because they had smaller amounts of other income. Partnerships are the category where the the marginal rates on gains and losses are closest (33.4 percent and 28.9 percent, respectively), which is consistent with a view that many partnership losses reflect tax shelter losses incurred by taxpayers with substantial amounts of other income.

The differences in marginal rates before and after TRA are striking.

(1) On net and for returns with gains, each type of business received a reduction in marginal tax rates. Returns with Subchapter S gains showed the largest cut, from 43.6 percent to 27-28 percent.

(2) The range of marginal tax rates on returns with gains of different types narrowed substantially, from a 15-point range to only a 5-point range.

(3) The marginal rates on returns with passive losses from Subchapter S corporations or partnerships have dropped extremely low--5.5 percent and 9.0 percent, respectively.

The implications of the low marginal rates on passive losses are interesting. On one hand, the low rates indicate how little value passive losses have in the 1988 tax year. When the phase-in of the passive loss limitation is complete in 1991, passive losses will have even less current-year tax value. On the other hand, these same low rates would be applied to additional passive income. If passive income became widely available to taxpayers with passive losses, the potential revenue loss could be substantial. On a dollar of partnership income in 1988, Table 8 indicates that more than half the tax revenue could be lost if it were deemed passive income and earned by a partner with passive losses, compared to the taxes it would generate if it went to any other average partner: 9 cents vs. 22 to 25 cents. These marginal rates indicate the importance for protecting revenue of the Treasury regulations to distinguish passive income from portfolio income and the provision of the Omnibus Budget Reconciliation Act of 1987 that characterized income from MLP's as portfolio income.

An additional consequence of a broad definition of passive income would be an efficiency loss. If partners with gains or active losses facing a marginal rate of about 23 percent generally require an 8 percent pre-tax return on an investment, taxpayers with passive partnership losses would require only a 6.8 percent pre-tax return to achieve the same after-tax return.

IV. CONCLUSION

This paper has surveyed issues and data related to the taxation of noncorporate business before and after the Tax Reform Act of 1986. Before TRA, although income from business and capital appeared to be shrinking relative to the rest of the economy, this trend did not appear noticeably stronger in the corporate than in the noncorporate sector. In terms of income reported on tax returns, the rate of growth in corporate income was slowing but this was not true for noncorporate business.

At the individual level, where most taxes on income from noncorporate business are paid, there was evidence that taxes on income from noncorporate business, may have represented a declining share of total individual income taxes. In addition, a gap appeared to be growing between income of Subchapter S corporations and partnerships appearing on the business returns and on individual returns. Although the explanation is not clear, some of the missing Subchapter S income may flow to trusts and estates, while under-reporting may also be involved. For partnerships, much of the apparent gap may reflect income going to partners other than individuals. Indeed, data for 1983 indicate that corporations and other types of partners receive a considerable fraction of partnership income, particularly in the mining and transportation industries.

After TRA, income from both corporate and noncorporate business will receive substantial tax increases in spite of reductions in marginal tax

rates. Corporations will see a 29 percent increase over the taxes they would have paid if TRA had not been enacted. Individuals will pay 60 percent more on income from noncorporate business with TRA (or 15 percent more if the tax shelter provisions are excluded). Although taxes will be higher in both sectors, evidence available suggests that TRA narrowed the differentials in effective tax rates between the corporate and noncorporate sectors, and "leveled the playing field" on which investment decisions are made. At the individual level, taxpayers with income from noncorporate business consistently received cuts in the marginal tax rates on that income. The passive loss limitations so reduced marginal rates on passive losses that they will generate revenue and efficiency problems if passive income is easily available to offset passive losses.

FOOTNOTES

¹ Alan Auerbach and James Poterba, "Why Have Corporate Tax Revenues Declined?" in *Tax Policy and the Economy*, Lawrence, H. Summers, ed. (NBER, 1987).

² The term "noncorporate business" in this paper generally refers to sole proprietorships, partnerships, rental activities (at the individual level), and Subchapter S corporations. Although technically corporations, for tax purposes Subchapter S firms are more similar to partnerships than to corporations.

³ Inflation raises nominal interest rates, but interest payments are tax-deductible. Unanticipated inflation also erodes the value of debt. The combination makes debt-financing more attractive during periods of inflation than during price stability.

⁴ Partnership income adjusts ordinary income reported on partnership returns to remove income or losses from other partnerships (to eliminate double counting) and to add back payments to partners. This adjusted measure provides a better reflection of the aggregate income provided to the partners.

⁵ For further discussion of the problems of determining partnership income that is potentially taxable, see Lowell Dworin, "An Analysis of Partnership Activity, 1981-1983," *SOI Bulletin*, Spring 1986. The problems are similar for Subchapter S corporations.

⁶ Subchapter S corporations are shown separately, but they are also reflected in the corporation statistics.

⁷ Income from Subchapter S corporations is not separately identified on returns filed by estates and trusts, but rather it is reported under "Other Income," along with any wages and salaries received by a decedent's estate, retirement account distributions that are counted as ordinary income, and certain refunds from overpayment of windfall profit taxes. Presumably, income from Subchapter S corporations account for the bulk of "Other Income." Data for 1982 come from Gary Estep, "Fiduciary Income Tax Returns, 1982," *SOI Bulletin*, Spring 1985.

⁸ Schedule K-1 tells the individual partner his or her share of each partnership item, and Schedule K aggregates the K-1's overall partners.

⁹ Income and loss here are not adjusted as they are in Table 2 to remove the double counting of income from other partnerships nor to restore guaranteed payments to partners to partnership income.

¹⁰ See the testimony of Assistant Secretary of the Treasury J. Roger Mentz, before the Subcommittee on Select Revenue Measures, Committee on Ways and Means of the U.S. House of Representatives on June 30, 1987. Also, see pages 943-959 of the Conference Report accompanying the Omnibus Budget Reconciliation Act of 1987, House of Representatives, December 21, 1987.

¹¹ The Omnibus Budget Reconciliation Act of 1987 allowed partnerships, S corporations, and personal service corporations to keep their fiscal years if they made "required payments" to offset the tax benefits deferral.

¹² This is lower than a \$41 billion estimate made by Larry L. Dildine in "Effect on Industry," in *Tax Reform and the U.S. Economy*, Joseph A. Pechman, ed. (The Brookings Institution: 1987). Much of the difference may be that Dildine applies the rate cuts to more sources of income than does the estimate presented here. For this estimate, noncorporate business income equals net income from sole proprietorships, partnerships, Subchapter S corporations, rents and royalties, and farms.

¹³ See more extensive discussions and analyses of the issues involved in calculating effective tax rates, see Don Fullerton, Robert Gillette, and James Mackie, "Investment Incentives Under the Tax Reform Act of 1986," in *Compendium of Tax Research, 1987*, Office of Tax Analysis, U.S. Department of the Treasury (December 1987); and Alan Auerbach, "The Tax Reform Act of 1986 and the Cost of Capital," *Journal of Economic Perspectives*, Summer 1987.

¹⁴ See Table 5.11 of Fullerton *et al.*

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